S243-3

Calendar No. 645

101ST CONGRESS *2d Session*	SENATE	REPORT 101-337

THE SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1990

REPORT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

TO ACCOMPANY

S. 647

JUNE 26 (legislative day, JUNE 11), 1990.—Ordered to be printed

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U.S. GOVERNMENT PRINTING OFFICE

39-010 WASHINGTON : 1990

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Mr. RIEGLE, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

[To accompany S. 647]

INTRODUCTION

On May 4, 1990, the Senate Committee on Banking, Housing, and Urban Affairs marked up and ordered to be reported a bill, the Securities Law Enforcement Remedies Act of 1990, to amend the Federal securities laws in order to provide additional enforcement remedies for violations of those laws. The Committee voted to adopt the legislation by a voice vote, without objection, and to report the bill to the Senate.

PURPOSE AND SUMMARY

The Securities Law Enforcement Remedies Act is designed to strengthen the enforcement powers of the Securities and Exchange Commission (SEC) and provide the agency with a broader range of remedies to protect investors and maintain the integrity of the nation's securities markets. The legislation addresses the disturbing levels of financial fraud, stock manipulation and other illegal activity in the U.S. markets by authorizing new civil money penalties to deter unlawful conduct by increasing the financial consequences of securities law violations. It provides the SEC with new cease-and-desist authority, enhancing the agency's ability to protect investor funds when they are at risk, and broadening the SEC's administrative procedures to curb a wider range of securities violations. The bill is designed to combat recidivism and protect investors from those whose unlawful conduct demonstrates their unfitness to serve as an officer or director by expressly authorizing courts to

bar certain individuals who have engaged in fraudulent activity from positions of trust in public corporations. The legislation also facilitates the SEC's ability to obtain information from criminal law enforcement authorities without engaging in costly and time-consuming duplication of efforts, in order to optimize the use of limited government resources.

The strength of the U.S. capital markets rests on investor confidence in the markets. Since 1934, the SEC has been the primary law enforcement agency charged with protecting investors and ensuring the integrity of the U.S. securities markets, and it has pursued its mission with vigor, a high degree of professionalism and effectiveness. However, in recent years, the markets under the SEC's jurisdiction have grown dramatically in size and complexity, and the SEC's ability to protect investors and to deter law violations increasingly has been challenged. In the budget environment of the 1980's, SEC staff levels did not keep pace with the growth in the markets and institutions under its supervision. For example, between 1980 and 1989, the number of securities firms increased approximately 90 percent; the number of investment companies grew more than 145 percent, the number of investment advisers more than tripled, the number of registration statements filed annually with the SEC doubled, and the number of tender offer filings increased over 670 percent. SEC staff levels increased only slightly during this period.

Potential law violators have been lured by the prospects of enormous profits, in situations where the risk of detection by financial regulators has appeared small. Recent years have witnessed the biggest insider trading scandals in history, widespread incidences of fraudulent financial reporting by financial institutions and other corporations, illegal activity in connection with tender offers, billions of dollars of losses to small investors as a result of illegal activity in the "penny stock" market, market manipulation and other illegal trading activity, and fraudulent and misleading disclosures in the sale of securities. In 1989, the SEC received 44,977 complaints and inquiries from investors, an increase of more than 260% since 1982.

In this environment, the ability to manage a growing enforcement workload and to impose adequate remedies to deter law violations is critical to the success of the SEC's enforcement program and, therefore, is necessary for investor protection. While the SEC has sought, and Congress has enacted, additional remedies to assist the SEC in combating insider trading and related violations, broader remedies are needed to address a wider range of securities law violations. Accordingly, the major provisions of the bill give the SEC greater authority and flexibility in the conduct of its law enforcement efforts and strengthen the remedial effect of the SEC's enforcement program.

New civil money penalties for securities law violations.—The legislation is designed to strengthen and broaden the SEC's enforcement powers by authorizing new civil money penalties for a range of securities violations. Fines may be imposed by courts in civil enforcement actions brought by the SEC, and may also be imposed by the SEC in administrative proceedings.

There are three tiers of maximum penalty amounts. The *first tier* maximum penalties are $5,000 for each violation by a natural person and $50,000 for each violation by any other person. The *second tier* maximum penalties, where the violation involves "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," are $50,000 for each violation by a natural person and $250,000 for each violation by others. The *third tier* maximum amounts, where the violation involves "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" *and* the violation "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons" (or, in the case of an administrative penalty, "resulted in substantial pecuniary gain to the person who committed" the violation), are $100,000 for each violation by a natural person and $500,000 for each violation by others.

The legislation provides that where a penalty is determined by a court, it may not exceed the higher of the maximum dollar amount set by statute or the gross amount of pecuniary gain to the defendant. Where a money penalty is determined in an administrative proceeding, it may not exceed the maximum dollar amount. The legislation also sets forth certain mitigating and other factors that may be considered by the SEC in determining whether, and to what extent, an administrative penalty would serve the public interest. In addition, the legislation provides that the SEC can order disgorgement in administrative proceedings.

New cease-and-desist authority.—The legislation gives the SEC both temporary and permanent cease-and-desist authority to enforce the provisions of the securities laws. A *permanent* order directs the respondent to refrain from future violations and may also order the respondent to take affirmative steps to ensure compliance. Disgorgement of unlawful gains also may be ordered. Under the legislation, a respondent must be provided with notice and an opportunity for a hearing before a permanent order is issued. The hearing must take place no earlier than 30 days and no later than 60 days after issuance of the notice, unless the SEC and respondent agree to an earlier or later date. A decision by an administrative law judge may be appealed to the SEC and, subsequently, to a U.S. court of appeals.

A *temporary* order may be issued by the SEC only with respect to persons or entities acting as broker-dealers, investment advisers, investment companies, transfer agents, or other persons or entities which are, or are required to be, registered with the SEC or associated with such persons. The SEC must determine that a violation is likely to result in "significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest," and notice must be given unless "impracticable or contrary to the public interest." A temporary order may be set aside by the SEC or a court.

Statutory authority to bar persons from serving as corporate officers and directors.—The legislation expressly affirms the inherent authority of a court to bar persons who are found to have violated Sections 17(a)(1) of the Securities Act of 1933 (Securities Act) and 10(b) of the Securities Exchange Act of 1934 (Exchange Act), the antifraud provisions of those laws, or the rules and regulations

thereunder, from serving as an officer or director of a publicly-held company. This express statutory remedy is not available in every case, however. The legislation requires that the person's conduct "demonstrates substantial unfitness to serve as an officer or director" prior to ordering a bar under this provision.

SEC access to grand jury material.—In a provision similar to provisions adopted by Congress as part of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA),[1] the legislation amends the Federal Criminal Code by permitting a court, on motion by an attorney for the government, to direct disclosure of grand jury material developed in an investigation of conduct that may constitute a violation of the securities laws. The material may be disclosed only to identified personnel of the SEC. The court must find that there is a "substantial need in the public interest" to release the material.

History of the Legislation

The Securities Law Enforcement Remedies Act of 1989, S. 647, was introduced by Senators Dodd and Heinz on March 17, 1989. The legislation originally was submitted to Congress by the SEC on September 28, 1988 and was developed, in part, in response to certain recommendations of the National Commission on Fraudulent Financial Reporting. On January 18, 1989, the SEC's legislative proposal was resubmitted, with certain modifications, pursuant to Section 3(c) of the Insider Trading and Securities Fraud Enforcement Act of 1988, which directed the SEC to submit "any recommendations the Commission considers appropriate with respect to the extension of the Commission's authority to seek civil penalties or impose administrative fines for violations other than [insider trading]." [2] Following the submission and introduction of the legislation, the Committee reviewed evidence and heard testimony from numerous regulators, market participants and other experts on securities law enforcement issues.

The Securities Subcommittee held a hearing on S. 647 and other legislation on April 18, 1989, as part of hearings on "Reauthorizations for the Securities and Exchange Commission, 1990–1992." [3] The SEC's then Chairman David S. Ruder testified that there was a need to expand enforcement remedies available to the SEC in order to enhance the agency's effectiveness and the deterrent effect of its enforcement program.

On February 1, 1990, the Securities Subcommittee held a hearing on S. 647 and other issues relating to the effectiveness of the SEC's enforcement program. SEC Chairman Richard C. Breeden testified on behalf of the SEC in support of the legislation, with certain revisions. The revisions included new provisions giving the SEC cease-and-desist authority, authorizing access to grand jury materials under certain conditions, and permitting the SEC in its administrative proceedings to issue orders of accounting and disgorgement. The SEC also recommended the deletion of provisions that would have given the SEC administrative authority to bar or suspend per-

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[1] Pub. L. No. 101-73, 103 Stat. 183 (1989).
[2] Pub. L. No. 100-74, 102 Stat. 4677 (1988).
[3] S. Hrg. 103-131.

sons from serving as officers and directors of reporting companies and recommended further modification of provisions expressly affirming the authority of courts to impose these sanctions. Other witnesses at the hearing included Gary G. Lynch, Esq., former SEC Director of Enforcement; the Honorable Stanley Sporkin, Federal District Court Judge and former SEC Director of Enforcement; Aulana L. Peters, Esq., former SEC Commissioner; and Victor Futter, Esq., representing the American Society of Corporate Secretaries.

On Februry 6, 1990, the Securities Subcommittee held a hearing on S. 647 and enforcement issues relating to small investors. Witnesses at the hearing were: Richard G. Ketchum, Director, SEC Division of Market Regulation; Joseph I. Goldstein, Associate Director, SEC Division of Enforcement; Frank J. Wilson, Executive Vice President and General Counsel, National Association of Securities Dealers; Susan E. Bryant, President, North American Securities Administrators Association; Hartley T. Bernstein, Esq.; Brian N. Smiley, Esq.; and Bobby and Debra Thomason. Witnesses strongly supported the legislation as a means of deterring and punishing penny stock fraud and preventing recidivists from continuing to defraud investors.

On February 9, 1990, SEC submitted a revised version of S. 647, which reflected the changes to the legislation recommended by the SEC at the February 1, 1990 hearing.

On May 24, 1990, the Committee marked up and passed, by a voice vote, a substantially revised Committee Print of S. 647. The Committee Print included provisions intended to clarify the scope of certain provisions and institute procedural safeguards, such as providing a three-tiered structure for the amounts of civil money penalties, providing for notice and limiting temporary cease-and-desist provisions to actions against regulated entities, and further clarifying circumstances in which an officer and director bar would be appropriate. The Committee adopted amendments modifying the standard for access to grand jury materials and giving the SEC rulemaking authority to prevent discrimination among signature guarantors by transfer agents.

Background

The SEC is an enforcement agency. Through its enforcement program, it protects the investing public by investigating, prosecuting and seeking sanctions for violations of the federal securities laws. The enforcement program's principal legislative mandates are the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Each law contains explicit authority for the SEC to conduct investigations and, where unlawful conduct is discovered, to bring enforcement actions in a federal court, institute administrative proceedings, or refer the matter to the Attorney General for criminal prosecution. These laws extend to a broad range of securities activities, including initial offerings of securities, periodic reporting by companies with registered securities, mergers and acquisitions, securities trading, and the fair treatment of investors by regulated

entities such as the stock and options exchanges, broker-dealers, investment companies and investment advisers.

Effective law enforcement preserves the integrity of the securities markets and maintains investor confidence, which is vital for capital formation. It assures investors that those who participate in the markets will play by the same rules, by ensuring that those who break the rules will be detected, prosecuted, and appropriately sanctioned. The SEC's mandate to enforce the Federal securities laws is wide-ranging. The SEC has brought enforcement actions against investment advisers and penny stock operators who have defrauded individual investors of millions of dollars; large multinational corporations that have issued fraudulent financial statements and other reports to the investing public; financial institutions that have engaged in activities that have put both investor and taxpayer funds at risk; brokers and dealers who have engaged in illegal securities trading through offshore accounts; and many others who have participated in other unlawful activities in violation of the Federal securities laws. As the markets under its jurisdiction have grown dramatically in size and complexity, particularly in the last decade, the SEC's law enforcement task has become increasingly difficult. Investigations involve more complex issues of fact and law, the collection of evidence from foreign countries and the prosecution of defendants who, in many cases, have the financial means to fight and delay SEC actions for long periods of time, thus requiring a greater commitment of the SEC's resources.

The SEC, with its limited staff and other resources, cannot place a "cop on every street corner." To be effective, its enforcement program must do more than detect and prosecute law violators and assist in the recovery of investor funds. It must have a strong remedial effect, so that potential law violators will be deterred from engaging in unlawful activity that may lead to swift enforcement action and significant penalties. Therefore, in recent years, the Committee and the Congress have worked closely with the SEC and other financial regulators to develop new enforcement and regulatory tools to assist in detecting and taking action against fraudulent and illegal activity in the securities markets.

Passage of the Insider Trading Sanctions Act of 1984.—S. 647 represents another step in a process of strengthening the SEC's enforcement authority that began with passage of the Insider Trading Sanctions Act of 1984 (ITSA).[4] That legislation, for the first time, gave the SEC the authority to seek civil money penalties for insider trading. Prior to passage of ITSA, the principal remedy available to the SEC was an injunction against further securities law violations and disgorgement of unlawful profits. Although an injunction subjects a defendant to possible criminal contempt proceedings if he violates the same law again, some critics have argued that an injunction serves only as a "slap on the wrist." It also has been argued that disgorgement of ill-gotten gains is an insufficient deterrrent, because it merely restores a defendant to his original position, without extracting a cost for his illegal behavior. In a sense,

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[4] Pub. L. No. 98-376, 98 Stat. 1264 (1984). These provisions are now codified in new Section 21A of the Exchange Act pursuant to the Insider Trading and Securities Fraud Enforcement Act of 1988, note 2, *supra*.

prior to the enactment of ITSA, there was a financial "risk" to a person engaging in insider trading. If caught, the insider trader only had to surrender his ill-gotten gains. Thus, it became clear that stronger remedial measures were necessary to deter insider trading. ITSA added section 21(d)(2)(A) to the Exchange Act to provide that whenever a person has illegally purchased or sold a security while in the possession of material non-public information, the SEC may seek, and a federal court may impose, a civil money penalty in an amount up to three times the profit gained or loss avoided by the law violator.

Passage of the Insider Trading and Securities Fraud Enforcement Act of 1988.—Although sanctions under ITSA had been successfully used by the SEC in a number of insider trading cases, the SEC and Congress determined that additional enforcement tools were necesssary to combat the continued incidence of insider trading. There was a perception that the securities industry, in particular broker-dealers, were not doing enough to detect or deter insider trading. As a result, Congress in 1988 enacted the "Insider Trading and Securities Fraud Enforcement Act" (ITSFEA).[5] This legislation imposed specific responsibilities on broker-dealers, investment advisers, and other securities firms to take steps to detect and deter illegal insider trading activity, and it authorized the imposition of substantial money penalties on "controlling" persons for failure to meet the new responsibilities.

However, insider trading cases represent only a small fraction of enforcement cases brought by the SEC. Thus, Congress, private sector groups and the SEC have asked whether civil fines or other new enforcement remedies may be warranted for violations other than insider trading that are just as harmful to investors and the integrity of the markets. As a result, section 3(c) of ITSFEA directed the SEC to submit to Congress the SEC's recommendations "with respect to the Commission's authority to seek civil penalties or impose administrative fines for violations other than [insider trading]."

Recommendations of the Treadway Commission.—In 1987, the National Commission on Fraudulent Financial Reporting (the Treadway Commission) issued a report recommending that the SEC be given a broader range of enforcement remedies to deter financial fraud.[6] The Treadway Commission was a private sector initiative sponsored by the accounting industry to study the financial reporting system in the United States and identify steps necessary to reduce the incidence of fraudulent financial reporting. The Treadway Commission report contained numerous recommendations for changes to be made by the accounting profession itself, by corporate officials, by the SEC and by the Congress. It recommended that legislation be enacted to give the SEC the authority to obtain civil money penalties, authority to bar officers and directors from serving in such capacities for public companies, and authority to obtain "cease and desist" orders. Although the recommendations of the Treadway Commission sought to address financial fraud viola-

[5] Note 2, *supra*.
[6] *Report of the National Commission on Fraudulent Financial Reporting* (1987).

tions, the SEC, after study, recommended that new civil remedies be adopted for a wider range of securities law violations.

Thus, the Securities Law Enforcement Remedies Act incorporates these recommendations to add tougher and more flexible enforcement powers to the SEC's arsenal of weapons to combat violations of the Federal securities laws. The legislation builds upon and expands the SEC's existing authority to request civil fines for insider trading and related violations by authorizing fines for a broader range of securities law violations, including disclosure violations, stock manipulation, falsification of books and records, and misleading financial reporting. The Committee believes the additional sanctioning authority provided in the legislation will enable the SEC to tailor enforcement remedies more precisely to the particular violation, thereby maximizing the effectiveness of its enforcement actions and enhancing the deterrent effect of its enforcement program. New cease-and-desist authority will enable the SEC to move quickly in administrative proceedings, particularly in those situations where investor funds are at risk. The codification of courts' authority to impose bars and suspensions with respect to officers and directors of public corporations will provide further notice to potential law violators of the availability of this remedy, particularly in cases where an individual's conduct demonstrates unfitness to serve as an officer or director. Finally, by providing greater access to grand jury material relating to securities law violations, the legislation will provide greater efficiency in the use of government enforcement resources and will enhance the SEC's ability to protect investors.

THE LEGISLATION

A. CIVIL MONEY PENALTIES AND DISGORGEMENT

The legislation authorizes the SEC to seek civil money penalties in court proceedings and to impose penalties and order disgorgement in adminstrative proceedings for violations of the federal securities laws.[7]

The SEC's current authority to obtain or impose civil money penalties is generally limited to insider trading violations.[8] Thus, a vast array of unlawful conduct is not subject to this remedy. Consequently, in many instances the remedies available are court-ordered injunctions prohibiting securities law violators from engaging in the same misconduct in the future, and other forms of ancillary relief, such as corrective disclosure for reporting violations. However, with respect to certain types of securities law violators, especially those who have demonstrated a prior disregard for the law, the threat of an injunction, corrective disclosure or other ancillary relief may have very little deterrent effect.

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[7] Courts in civil proceedings currently may order disgorgement under their equitable powers. *See, e.g., SEC* v. *Materia*, 745 F. 2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1984).

[8] In addition to the authority to seek civil money penalties in insider trading cases under ITSA and ITSFEA, there are two other provisions of limited applicability in the Federal securities laws which provide for civil money penalties. First, under the Foreign Corrupt Practices Act, the SEC may seek a civil money penalty up to $10,000 against an issuer, or certain other persons, who make foreign payments in violation of Section 30A of the Exchange Act. Second, under Section 32(b) of the Exchange Act, issuers may be assessed a civil penalty of $100 per day for failure to file certain required information.

In a number of enforcement cases, the SEC successfully has urged courts to invoke their equitable powers to require that law violators "disgorge" the amounts by which they are unjustly enriched. A recent judicial decision clarified that the SEC may obtain this relief when there are violations of disclosure and filing requirements under the Federal securities laws.[9] Nonetheless, disgorgement requires only that the law violator give up his unlawful gains and exacts no cost for his actions.

Congress previously has provided other Federal regulatory agencies with civil fining authority. For example, the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC), the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), and the Office of Thrift Supervision (OTS) each have the statutory authority to seek or impose civil money penalties for violations of a wide range of laws under their jurisdiction. In response to widespread fraud in the savings and loan industry, Congress recently underscored the importance of civil money penalties by authorizing the financial institution regulators to impose substantially greater fines (as high as one million dollars a day) for violations of the banking laws. In addition, the selfregulatory organizations under the jurisdiction of the SEC also have board authority to impose fines for a range of violations. Accordingly, the Committee believes it is appropriate for the SEC to be given broad civil fining authority as well.

As stated in a report to the Administrative Conference of the United States,

> [t]he civil fine has assumed a place of paramount importance in the compliance arsenal of most federal regulatory agencies. It is today almost inconceivable that Congress would authorize a major administrative regulatory program without empowering the enforcing agency to impose civil monetary penalties as a sanction. It has become commonplace for observers of the administrative process, disillusioned with traditional criminal, injunctive and license-removal sanctions, to urge greater reliance on civil fines as an enforcement device.[10]

Some commentators have argued that the authority to impose or seek civil money penalties could undermine the SEC's enforcement program, encouraging litigation rather than settlements, resulting in a punitive rather than remedial focus in enforcement efforts. However, the Committee believes that civil money penalties will enhance the remedial nature of the SEC's enforcement program. Civil penalty authority for many years has been a critical component of the law enforcement efforts of other Federal agencies, and the availability of civil money penalties has strengthened the SEC's insider trading enforcement efforts. The authority provided by S. 647 will give the SEC and the courts the flexibility to better tailor

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[9] *SEC* v. *First City Financial Corp.*, 890 F. 2d 1215 (D.C. Cir. 1989).

[10] Colin S. Diver, Report to the Administrative Conference of the United States Concerning the Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies 1 (May 1979).

a remedy to the facts and circumstances of the violation. Thus, civil money penalties may be imposed when other remedies currently available to the SEC may be too severe or, alternatively, too weak. The availability of civil money penalties for violations of the Federal securities laws also will serve to increase deterrence and help maintain public confidence in the integrity of the markets.

Increased deterrence.—The SEC's primary statutory remedy for securities law violations has been the civil injunction, together with such ancillary relief (especially disgorgement of ill-gotten gains) as the courts find appropriate in a particular case.[11] The Committee believes that injunctions against future violations, together with appropriate ancillary relief, continue to have an important deterrent effect. Nothing in the legislation should be viewed as diminishing the importance of injunctive action as a means of protecting the investing public against future violations, and this remedy should continue to be available to the SEC. In addition to this authority, the Committee believes that the money penalties proposed in this legislation are needed to provide financial disincentives to persons from committing a wide range of securities law violations.

Many violators of the securities laws, such as those who engage in penny stock fraud, market manipulation, and fraudulent financial reporting, reap enormous profits from their illegal activity. Absent a criminal prosecution or a private suit for damages, however, even the defendant who makes a deliberate decision to violate the law and causes significant harm to investors does not risk any civil monetary sanction more severe than an order of disgorgement. Since disgorgement merely requires the return of wrongfully obtained profits, it does not impose any meaningful economic cost on the law violator. The Committee, therefore, concluded that authority to seek or impose substantial money penalties, in addition to the disgorgement of profits, is necessary for the deterrence of securities law violations that otherwise would provide great financial returns to the violator.

The proposed civil money penalties also will provide a financial disincentive to violations that reflect an unwillingness to incur the cost of full compliance with the securities laws. In such cases, investors may suffer significant losses or be exposed to significant risk of loss, even though the violations may not involve affirmative conduct to defraud investors. For example, a broker-dealer or an investment company may fail to comply with regulatory requirements simply because it is unwilling to devote the resources necessary to comply with these statutory objectives. As a result, there may be violations of bookkeeping provisions or the SEC's customer protection rule, which requires that customers' fully paid and

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[11] For example, this relief has included orders: directing disgorgement of unlawful profits, *SEC* v. *Materia*, 745 F. 2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1984) and *SEC* v. *First City Financial Corp.*, 890 F. 2d 1215 (D.C. Cir. 1989); appointing a special agent to conduct an investigation or insure compliance, *SEC* v. *Beisinger Indus. Corp.*, 552 F. 2d 15, 18 (1st Cir. 1977); setting aside a merger, *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 386 (1970); ousting or appointing directors, *see International Controls Corp.* v. *Vesco*, 490 F. 2d 1334 (2d. Cir.), *cert. denied*, 417 U.S. 932 (1974); freezing assets, *Deckert* v. *Independence Shares Corp.*, 311 U.S. 282 (1940); establishing an audit committee, *SEC* v. *Mattell, Inc.*, 4 S.E.C. Doc. 724, [1974-75] Fed. Sec. L. Rep. (CCH) paragraph 94,754 (D.D.C. 1974); and requiring a defendant to perform specified acts not otherwise required by law, *Wright* v. *Heizer Corp.*, 560 F. 2d 236 (7th Cir. 1977).

excess margin securities be maintained in a separate account, and customers may be exposed to a serious risk of loss. To the extent that violations of the Federal securities laws are motivated by a desire to maximize profits by reducing costs, the possibility of civil money penalties will improve compliance with the law and have a significant remedial effect.

The proposed authority will enable the SEC and the courts to deal more effectively with the problem of recidivist violators. The SEC increasingly has been confronted with persons who violate the securities laws after they have been sanctioned for the same or similar conduct. The extent of this recidivism reflects the inadequacy of the SEC's current remedial authority. If a respondent engages in conduct that violates an SEC administrative order, the SEC's only remedy is to seek a mandatory injunction directing compliance with its order. Moreover, although a defendant who violates a court injunction may be prosecuted in a criminal contempt action, the criminal standard of proof is difficult to meet, and the contempt remedy does not address unlawful conduct that is outside the scope of the original injunction. Providing authority to seek or impose civil money penalties will address the problem of recidivism by increasing the costs associated with repeated securities law violations. Both the SEC and the courts may take prior violations into account when imposing civil money penalties, thereby achieving greater deterrence against violators who are not deterred by the civil and administrative remedies currently available.

Increased flexibility.—In addition to increasing deterrence, civil money penalties will provide both the courts and the SEC with greater flexibility to tailor a remedy to the seriousness of the violation. This flexibility is a necessary adjunct to the SEC's administrative proceedings against registered broker-dealers and other regulated entities. Current law provides that if the SEC finds that a broker-dealer has willfully violated the securities laws, it may impose a variety of remedial sanctions, including a censure, revocation of the firm's registration, or the imposition of other appropriate limitations on the firm's regulated activities. In practice, this means the SEC often must choose between remedies that are either too weak or too severe.

For some firms, a censure may provide relatively little deterrence against future violations. However, revocation of a firm's registration or temporary suspension of its operations could impose hardship on a firm's customers, public shareholders, and innocent employees. With the option of imposing a monetary penalty, the SEC may appropriately sanction a violation requiring a penalty more severe than censure, but without the adverse consequences of a suspension or revocation.[12]

The Committee anticipates that the SEC will not seek or impose a civil money penalty in every case. For example, when a failure to comply with SEC requirements involves isolated and unintentional

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[12] As long ago as 1972, a Commission Advisory Committee on Enforcement Policies and Practices (the Wells Committee) recommended that the SEC consider the use of civil money penalties in boker-dealer proceedings. *See* Report of the Advisory Committee on Enforcement Policies and Practices (June 1, 1972). The Wells Committee Report suggested that "the availability of money penalties would provide the Commission with substantially greater flexibility in fashioning a suitable remedy for this type of proceeding." *Id.* at 46.

conduct, the implementation of new procedures or a similar remedial measure may be the most appropriate resolution of the case. However, even if it cannot be shown to be intentional, a person's disregard of the customer protection rules, the broker-dealer net capital rules, or repeated violations of recordkeeping requirements, for example, may warrant a money penalty.[13]

Tiering of money penalties.—In light of the broad range of conduct to be addressed by this legislation, the Committee established three tiers of maximum penalty amounts, separated according to the gravity of the violation and the extent of harm threatened or caused by the violation.

The legislation as introduced set the maximum amounts for penalties in SEC or court proceedings at $100,000 per violation for violations by a natural person, and $500,000 per violation for violations by any other person (and, in civil actions, the greater of the dollar amounts specified or the gross pecuniary gain to the defendant as a result of the violation). Some commentators expressed concern that, without further limitation, the maximum penalty amounts could be imposed for minor, inadvertent violations that did not cause significant harm. Altought the Committee believed that, in practice, the courts and the SEC would administer the new penalties fairly, the Committee determined that the concerns raised could be addressed by providing a penalty structure in which different maximum penalties were provided, according to the gravity of the violation. The Committee determined that three tiers of maximum penalty amounts were appropriate, and, within each tier, the SEC or the courts can further tailor the sanctions of the violation. Under the legislation, penalties are payable into the Treasury, and the Attorney General is charged with enforcing collection of such penalties.

For SEC administrative proceedings, under the first tier, the penalty may not exceed $5,000 per violation for natural persons or $50,000 for other persons. If the violation involves fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, the penalty per violation may not exceed the second tier maximum of $50,000 for natural persons or $250,000 for other persons. If the act or omission involves fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and the act or omission results in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission, the penalty for each act or omission may not exceed the

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[13] Many other agencies have penalty authority with respect to conduct such as the failure to file reports, keep records, permit entry, or respond to agency inquiries. For example, the Federal Railway Safety Act authorizes the Secretary of Transportation to assess a civil penalty with a general maximum of $10,000 against any railroad or railroad employee or agent for any violation under that act, including recordkeeping violations. 45 U.S.C. 438. Repeated or grossly negligent violations may be fined up to $20,000 per violation. The Secretary of Transportation is also authorized to impost penalties of up to $1,000 per violation or $800,000 for a related series of violations for the manufacture, sale, delivery or importation of sub-standard motor vehcles. *See* National Traffic and Motor Vehicle Safety Act, 15 U.S.C. 1398. The Tariff of 1930 provides a civil penalty for the failure, including the failure due to negligence, to declare any article required to be declared under U.S. customs law. 19 U.S.C. 1497(a). The penalty consists of forfeiture of the article plus a fine equal to the value of the article, or, if the article is a controlled substance, ten times its value. *Id.*

third tier maximum of $100,000 for natural persons or $500,000 for other persons.

The same tiering of penalties applies to court proceedings, with one major difference: within each tier, the maximum penalty is the greater of the dollar amount specific *or* the gross amount of pecuniary gain to the defendant as a result of the violation.[14] The Committee intends the phase "gross amount of pecuniary gain to such defendant as a result of the violation" to mean the amount by which the defendant was unjustly enriched as a result of the violation.[15] Thus, for example, if a violation involves fraud and resulted in substantial losses to other persons, a court (in addition to ordering disgorgement of profits) may assess a civil penalty equal to a violator's gain, even when that gain exceeds the applicable $100,000 or $500,000 limitation. Under current law, a district court may assess a civil money penalty of up to three times the profits derived from an insider trading violation, based upon "the facts and circumstances" of the case. Penalties under ITSA are not fixed by a statutory maximum amount. S. 647 extends this principle of ITSA penalties to other types of securities law violations.

Penalties in administrative proceedings.—The proposed legislation authorizes the SEC to assess money penalties in administrative proceedings, by adding new provisions to the Exchange Act (new Section 21B), the Investment Company Act of 1940 (new Section 9(d)) and the Investment Advisers Act of 1940 (new Section 203(i)). These provisions permit the SEC to impose monetary penalties on persons who are found to have violated the Federal securities laws in proceedings under Section 15(b)(4), 15(b)(6), 15B, 15C, and 17A of the Exchange Act, under Section 9(b) of the Investment Company Act, and under Sections 203 (e) and (f) of the Investment Advisers Act.

Sections 202, 301, and 401 of the legislation provide that the SEC may impose a penalty if it finds, on the record after notice and opportunity for hearing, that the person committed the violation and that the penalty is in the public interest. Each of these provisions sets forth the following factors that the SEC may consider in determining whether, and to what extent, a penalty is in the public interest:

> (1) Whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
>
> (2) The harm to other persons resulting either directly or indirectly from such act or omission;
>
> (3) The extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;
>
> (4) Whether such person previously has been found by the SEC, another appropriate regulatory agency, or self-regulatory

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[14] The third tier for judicially-ordered penalties also drops the phrase "or results in substantial pecuniary gain to the person who committed the act or omission."

[15] "Gross amount of pecuniary gain" is used in Section 3571 of the Federal Criminal Code, 18 U.S.C. 3571(d), which authorizes a criminal fine equal to twice the defendant's gross pecuniary gain from an offense or twice the losses to others. In view of the different purposes served by this provision in S. 647, the Committee does not intend courts to be bound by previous interpretations of Section 3571.

organization to have violated the federal securities laws, state securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted of certain securities-related offenses;

(5) The need to deter such person and other persons from committing such acts or omissions; and

(6) Such other matters as justice may require.

The Committee believes that the determination to impose a penalty is appropriately based on consideration of the public interest. Under the legislation, the SEC may consider the specific factors enumerated in determining whether a penalty is in the public interest. The Committee recognizes that not all of the factors will apply in any given case, and that the factors that are applicable should not be accorded the same weight in every case. The factors are permissive considerations in the sense that the SEC may determine that a penalty is in the public interest even if a respondent presents evidence that one or a number of the factors is inapplicable.

The SEC has advised the Committee that the six factors generally reflect the type of analysis that the SEC makes in determining appropriate remedies under its current enforcement policy. The Committee believes that these standards provide guidance to the SEC and the public without being unnecessarily rigid.

The first factor is "whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." This factor recognizes that the SEC may assess the violator's culpability, including whether the violator acted with scienter. The SEC may assess penalties not only in cases involving fraud, but also in cases in which the respondent fails to satisfy a regulatory obligation (for example, an investment adviser who fails to maintain required books and records notwithstanding prior warnings). This factor is consistent with the three-tiered structure of the penalty provisions, which contemplate that lesser penalties will be assessed against those who are less culpable.

The second factor is "the harm to other persons resulting either directly or indirectly from such act or omission." This factor relates to the gravity of a violation and focuses primarily on the consequences of the violation to others.

The third factor is "the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior." While consideration of this factor does not address the respondent's underlying culpability, the fact of restitution may go toward mitigation of a civil money penalty. The phrase "any person" takes into account those situations in which the respondent may not be the only person unjustly enriched as a result of the violation.

The fourth factor is "whether such person previously has been found by the Commission, other appropriate regulatory agency, or self-regulatory organization to have violated the federal securities laws, state securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted by a

court of competent jurisdiction of violations of such laws or of any felony or misdemeanor described in [Section 15(b)(4)(B) of the Exchange Act or Section 203(e)(2) of the Investment Company Act]." This recognizes that the SEC may properly impose higher civil money penalties on recidivists than on first-time offenders. The SEC has applied other sanctions more stringently to recidivists.[16] This fourth factor will help in achieving the goal of improved deterrence through the use of money penalties, by providing flexibility to assess higher penalties when lesser ones have proven insufficient to deter the violative conduct.

The fifth factor is "the need to deter such person and other persons from committing such acts or omissions." This factor is an important consideration in cases in which the violation is one that requires strong deterrrence or where assessing civil money penalties is likely to encourage better compliance. For example, for some violations the effectiveness of deterrence may be a function of the economic gain to be derived from a violation and the probability that a violation will be detected. Indeed, this was the basis on which Congress determined to authorize subtantial penalties for insider trading violations. The Committee believes it is appropriate to enable the SEC to impose a higher penalty if the violation is of a type that is difficult to detect.

The SEC also may consider "such other matters as justice may require." This gives the SEC the latitude to take into account equitable considerations that are not foreseeable and not readily susceptible to statutory delineation. The SEC may wish to consider information similar to that specified in the other five factors, even though those factors are not directly implicated. For example, even when the second factor is not applicable because no actual harm has occurred, the SEC may wish to consider the threat of harm that a violation engendered. Indeed, the third tier of the three-tier structure of the penalty provisions contemplates that the SEC will consider the threat of harm in connection with the amount of penalty. That same threat may likewise bear on the consideration of whether to assess a penalty. Similarly, the SEC may wish to consider a history of noncompliance by a respondent even when the fourth factor is not involved because no prior adjudication has occurred. For example, in cases of failures to file periodic reports, the SEC may appropriately consider a prior history of delinquency even though the SEC had refrained from taking administrative or judicial action earlier.

The Committee also believes that the ability of respondents to pay a civil penalty is an important consideration in determining the amount of the penalty to be imposed. Sections 202, 301, and 401 of the legislation add Section 21B(d) to the Exchange Act, Section 9(d)(4) to the Investment Company Act, and Section 203(i)(4) to the Investment Advisers Act, to provide respondents an opportunity to present evidence about their ability to pay a penalty. Such evidence, for example, could include information relating to the extent of the respondent's ability to continue in business, the col-

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[16] *See e.g., Hammon* v. *SEC*, 817 F. 2d 106 (9th Cir. 1987) (court affirmed imposition of SEC sanctions against petitioner found to have engaged in repeated willful violations of record-keeping requirements under the Investment Advisers Act).

lectability of a penalty, claims of the United States or third parties upon the respondent's assets, and the amount of those assets. The SEC, in its discretion, would be able to consider this evidence in determining what sanction is in the public interest. The Committee believes it is appropriate that respondents have the obligation to present evidence of their ability to pay, since they have better access to their financial records than does the SEC.

SEC orders imposing a money penalty, like other final orders in administrative proceedings, may be appealed to the U.S. court of appeals in the circuit in which the respondent resides or has his principal place of business, or in the District of Columbia Circuit. Thus, while this legislation would empower the SEC to impose civil money penalties in certain of its administrative proceedings, its use of this sanction would be subject to judicial review in each case.

Disgorgement orders in administrative proceedings.—Sections 202, 301, and 401 of the legislation add Section 21B(e) to the Exchange Act, Section 9(e) to the Investment Company Act, and Section 203(j) to the Investment Advisers Act, respectively. Under the legislation, each of these sections provide that the SEC may enter disgorgement orders in its administrative proceedings. The SEC does not have express authority to order disgorgement under current law, although it has obtained agreements from respondents to disgorge profits or make restitution to injured customers as part of settlement of administrative proceedings.[17] The SEC currently may sanction a respondent taking into account the respondent's representation that it will disgorge profits or make restitution, while reserving the right to impose a more severe sanction if the respondent fails to do so.

The bill includes as a factor relating to the imposition of administrative penalties the extent to which a respondent has made restitution, and thus give a respondent an incentive voluntarily to disgorge ill-gotten gains. The Committee believes, however, that the SEC should have the express authority to order disgorgement in its administrative proceedings in order to ensure that respondents in administrative proceedings do not retain ill-gotten gains. In contrast to damage granted in private actions, which are designed to compensate the victims of a violation, disgorgement forces a defendant to give up the amount by which he was unjustly enriched.

Penalties in civil actions.—In addition to authorizing the SEC to impose money penalties in its own administrative proceedings, the legislation also authorizes the SEC to seek court orders imposing civil money penalties against persons who have violated the Federal securities laws.

These penalites may be imposed in addition to orders of disgorgement directing a defendant to return the full amount of profits derived from a violation, and other forms of equitable relief. When a civil money penalty is sought by the SEC, the district court will have discretion to determine whether a penalty should be imposed and the amount of such penalty. This discretion will permit the court to impose a civil money penalty even if it determined that injunctive or other equitable relief against the defendant was not

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[17] *See, e.g., In the Matter of Anderson & Strudwick, Inc.*, Exchange Act Release No. 22089, 33 SEC Doc. 286 (May 29, 1985).

warranted. Thus, for example the courts will have the flexibility to order injunctive or other equitable relief only, injunctive or other equitable relief and a penalty, or a penalty only, depending upon the facts of a particular case. Whether to impose a penalty, and the amount of such penalty, will be determined by the court in light of the facts and circumstances of the particular case.

The SEC's February 9, 1990 legislative proposal provided a minimum penalty for failure to comply with a cease-and-desist order issued for violations of Section 16(a) of the Exchange Act. The Committee determined not to include this provision in the legislation because it believes that the permanent cease-and-desist and civil penalty provisions will provide appropriate remedies in many cases of noncompliance. Nevertheless, the Committee is concerned about the disturbingly low level of compliance with that section.

The Committee believes that the civil money penalty provisions should be applicable to corporate issuers, and the legislation permits penalties against issuers. However, because the costs of such penalties may be passed on to shareholders, the Committee intends that a penalty be sought when the violation results in an improper benefit to shareholders. In cases in which shareholders are the principal victims of the violations, the Committee expects that the SEC, when appropriate, will seek penalties from the individual offenders acting for a corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issues will ultimately be paid by shareholders who were themselves victimized by the violations. The court also may consider the extent to which the passage of time has resulted in shareholder turnover.

The Committee also expects that the SEC will not ordinarily seek penalties against registered investment companies. Generally, an investment company is a managed portfolio of liquid assets, with all expenses being passed on to shareholders. While the legislation permits civil penalties based on violations of the Investment Company Act, the penalties generally would be assessed against the responsible individuals.

B. CEASE-AND DESIST AUTHORITY

The legislation gives the SEC authority to issue permanent and temporary cease-and-desist orders to enforce the provisions of the Securities Act, the Exchange Act, the Investment Company Act and the Investment Advisers Act.

In general, a cease-and-desist order is an administrative remedy that directs a person to refrain from engaging in conduct or a practice which violates the laws. The Committee believes the power to impose a cease-and-desist order will enhance the SEC's ability to flexibly tailor remedies to the facts and circumstances of a particular case. Cease-and-desist authority also will give the SEC a useful enforcement tool to be applied against certain conduct and practices for which currently available enforcement remedies might be inappropriate.

Under its current authority, the SEC typically addresses on-going violations of the federal securities law by filing a civil injunctive

action in federal district court. The SEC has been successful in urging courts to grant injunctive relief, including emergency relief, in the form of preliminary injunctions against further violations, temporary restraining orders, orders freezing assets, and the appointment of receivers. However, injunctive relief is not always appropriate. For example, imposition of a civil injunction may result in collateral consequences that are not necessary or appropriate.[18] Under the cease-and-desist authority provided in the legislation, the SEC may be able to resolve cases without protracted negotiation or litigation on that part of defendants seeking to avoid the collateral consequences of an injunction. Cease-and-desist authority also will provide the SEC with an alternative remedy against persons who commit isolated infractions and present a lesser threat to investors. Moreover, given the extremely congested nature of federal court dockets, which often results in considerable delays in cases being heard, the authority to issue an administrative cease-and-desist order will enable the SEC to respond in a more timely fashion to violate conduct or practices.

Under its current authority, the SEC also has the option of proceeding administratively in cases involving regulated entities. This authority has limitations, however. For example, in its proceedings against regulated entities or their associated persons, the SEC may not initiate enforcement actions against persons who are not associated (or seeking to become associated) with a regulated entity. The cease-and-desist authority under S. 647 will significantly broaden and enhance this authority by making an administrative forum available in virtually all types of cases within the SEC's jurisdiction. For example, if an issuer engaging in a self-underwritten offering of securities violated the broker-dealer registration provisions because its selling efforts were outside the safe-harbor provided by Exchange Act Rule 3a4–1, the SEC could enter a cease-and-desist order to halt further sales. This remedy also could be used to address unregistered offerings that violate Section 5 of the Securities Act. The Committee anticipates, however, that the SEC will continue to seek civil injunctive relief in cases involving the most serious violations.

A cease-and-desist order also will provide a more effective remedy than is currently available under Section 15(c)(4) of the Exchange Act, which gives the SEC authority to bring administrative proceedings against persons who fail to comply with the reporting provisions of the Exchange Act. A violation of a cease-and-desist order may be punishable by a court-imposed civil penalty in addition to a mandatory injunction directing compliance with the order. By contrast, the violation of a Section 15(c)(4) order does not result in any penalty other than a court order directing compliance, the subsequent violation of which may lead to a contempt proceeding. In addition, the legislation expressly permits the SEC to order disgorgement in conjunction with the cease-and-desist order.

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[18] These collateral effects might include the statutory disqualification of certain persons from serving as an officer or director of an investment company pursuant to Section 9(a)(2) of the Investment Company Act.

The Committee notes that various Federal agencies have long been authorized to issue cease-and-desist orders against persons who have violated or are about to violate statutory provisions administered by those agencies. For example, the CFTC is authorized to issue cease-and-desist orders when it finds that any person has manipulated or attempted to manipulate the price of any commodity, or has violated any provision of the Commodity Exchange Act or the rules, regulations or orders of the CFTC thereunder.[19] The Federal Trade Commission, the National Labor Relations Board, and each of the federal bank regulatory agencies also are empowered to issue cease-and-desist orders.[20] Indeed, of all the federal financial regulatory agencies, only the SEC does not have authority to issue a cease-and-desist order.

In view of the significant new authority to act through administrative proceedings granted to the SEC in S. 647, the Committee expects that the SEC will review its Rules of Practice to determine whether any changes to the administrative process are necessary or appropriate.

Permanent cease-and-desist orders.—Sections 102, 203, 301 and 401 add Section 8A to the Securities Act, Section 21C to the Exchange Act, Section 9(f) to the Investment Company Act, and Section 203(k) to the Investment Advisers Act, respectively, to authorize the SEC to issue cease-and-desist orders to enforce the provisions of these Acts. The legislation provides for both permanent and temporary cease-and-desist orders.

A permanent cease-and-desist order directs the respondent to refrain from future violations and could also order the respondent to make disgorgement or to take affirmative steps to ensure compliance. Before the SEC may issue a permanent order, the SEC must provide a respondent with notice and opportunity for a hearing. A hearing before an administrative law judge must be set to commence no earlier than thirty days and no later than sixty days after issuance of the notice, unless the respondent consented to an earlier or later date. A respondent has the right to appeal an adverse decision by an administrative law judge to the full SEC, which considers the evidence *de novo,* the same right that respondents currently have in other SEC administrative proceedings. If the SEC affirms on appeal, the entry of a permanent cease-and-desist order may be appealed to a U.S. court of appeals in the same way as any other SEC order entered under the securities laws. This procedure is similar to that provided under the Federal Deposit Insurance Act with respect to FDIC cease-and-desist proceedings.

Temporary cease-and-desist orders.—The legislation authorizes the SEC to issue a temporary cease-and-desist order against broker-dealers, investment advisers, investment companies, and other regulated entities and persons associated with them if it has determined that a respondent is engaging, or about to engage in a violation that is likely to result in signifciant dissipation of assets, conversion of property, or significant harm to investors, or that is oth-

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[19] *See* 7 U.S.C. 13(b).

[20] Federal Trade Commission Act, 15 U.S.C. 45 (a), (b) (deceptive trade practices); Labor-Management Relations Act, 29 U.S.C. 160(c) (unfair labor practices); Federal Deposit Insurance Act, 12 U.S.C. 1818(b) (as amended by FIRREA).

erwise likely to result in substantial harm to the public interest before the completion of a permanent cease-and-desist proceeding. A temporary order requires the respondent to refrain from a violation, or to take action to prevent a violation, pending a hearing on a permanent order.

The availability of a temporary cease-and-desist remedy will enable the SEC to take emergency action before completion of a cease-and-desist proceeding when necessary to prevent significant harm to investors or the dissipation or conversion of assets. The proposed legislation gives the SEC the ability to commence enforcement proceedings rapidly, especially when ongoing conduct places investors in continuing jeopardy. For example, such authority may be used when information comes to the attention of the SEC that a broker-dealer is soliciting penny stock purchases in violation of the new "cold-calling" rule (Exchange Act Rule 15c2–6). Purchases are often solicited by a large group of persons who place numerous telephone calls in rapid succession to potential investors. When ongoing violations of this sales practice rule are discovered, the SEC will be able to act immediately to stop further calls in violation of the rule. This will prevent further harm that could result from subjecting unsophisticated investors to high pressure sales techniques. In addition, this authority may be used to prevent the dissipation of assets when, for example, the SEC discovers that a broker-dealer is about to disburse proceeds on a fraudulently closed "all or none" offering of penny stock, in violation of Exchange Act Rule 15c2–6. Issuance of a temporary cease-and-desist order also may be appropriate when the SEC learns that a mutual fund's books and records are so inadequate that shares of the fund cannot be properly priced. The SEC will be able to act with the new authority to protect investors by halting the further purchase or sale of fund shares at incorrect values until the shares may be properly priced.

The issuance of a temporary cease-and-desist order also may be appropriate when emergency action is necessary to ensure that a registered broker-dealer maintains sufficient net capital. For example, the financial failure of Drexel Burnham Lambert Group, Inc., although not resulting in customer losses, illustrates the type of situation in which tempoary cease-and-desist authority would facilitate the SEC's ability to take prompt action for the purpose of protecting investor assets. Given the highly technical nature of the issues involved in such cases, the Committee believes that the SEC, as the financial regulator that monitors the operations of broker-dealers and which has the most expertise in measuring the adequacy of their capital, should have the authority to take such emergency action in appropriate circumstances.

The temporary cease-and-desist provisions have been crafted to provide important due process protections for respondents. In view of the potential significant consequences of a cease-and-desist order, the SEC, as a general matter, will be required to provide prior notice to the respondent before the temporary cease-and-desist order becomes effective, to enable the respondent to show cause why such an order should not be issued. However, the Committee recognizes that there are instances where prior notice is inappropriate. Therefore, if the SEC determines that giving notice is im-

practicable or contrary to the public interest, a temporary cease-and-desist order would become effective upon service. The Committee believes that prior notice would be contrary to the public interest when, for example, it is reasonably likely to result in a respondent's flight from prosecution, destruction of or tempering with evidence, transfer of assets or records, improper conversion of assets, impeding the SEC's ability to identify or trace the source or disposition of funds, or further harm to investors.

A respondent may seek judicial review of the SEC's determination to issue a temporary cease-and-desist order immediately or within ten days of service of the order, but the order will be effective and enforceable unless the court stays or suspends it. Moreover, at any time after a respondent has been served with a temporary cease-and-desist order he is permitted to apply to the SEC to have the order set aside, limited, or suspended. In addition, the SEC may vacate or modify a temporary order at any time, and the temporary order will immediately cease to be effective if the SEC, after conducting a hearing, determines that a permanent cease-and-desist order should not be issued. If the SEC does issue a permanent cease-and-desist order, the respondent may seek review of the SEC's determination in the appropriate Federal court of appeals.

The SEC may seek enforcement of both temporary and permanent cease-and-desist orders in Federal district court. In addition to seeking a court order directing compliance, the SEC may request, and the court may impose, a civil money penalty for each violation as provided for in this bill.

C. OFFICER AND DIRECTOR BARS

The legislation provides express statutory authority for Federal courts to bar or suspend certain individuals from serving as officers or directors of any company required to file reports with the SEC.

Sections 101 and 201 of the bill would amend Section 20(b) of the Securities Act and Section 21(d) of the Exchange Act, respectively, to expressly authorize the Federal courts to bar or suspend an individual who has violated Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act, or the rules or regulations thereunder, from serving as an officer or director of any company required to file reports with the SEC. The individual's conduct also must demonstrate substantial unfitness to serve as an officer or director. The court may tailor the bar to the particular facts and circumstances and impose the bar on a temporary or permanent basis. A permanent bar might be appropriate if the violation were particularly egregious or the violator was a recidivist.

Although this remedy represents a potentially severe sanction for individual misconduct, persons who have demonstrated a blatant disregard for the requirements of the Federal securities laws should not be placed in a position of trust with a publicly held corporation. Officers and directors have a fiduciary obligation to their shareholders. Moreover, their actions can directly affect the integrity of the securities markets. There is ample precedent for employing this kind of remedy. Banking regulators, for example, have broad authority to remove persons serving as officers and directors

of financial institutions and to prohibit their future service. Other participants in the securities business, such as broker-dealers and officers and directors of investment companies, also are subject to bars or suspensions.

Federal district courts already have wide latitude to order extraordinary relief pursuant to their inherent equitable powers to grant ancillary relief that is necessary and proper to effectuate the purposes of the Federal securities laws. This authority includes the power to bar a person from serving as officer or director of a company.[21] The codification of this remedy under certain circumstances in S. 647 provides further notice of the availability of this remedy, particularly in cases where an individual's conduct demonstrates substantial unfitness to serve as an officer or director. By codifying this authority with respect to certain conduct, however, the Committee does not intend to limit the inherent authority of a court to order such relief when it is necessary or appropriate in other cases, or restrict the authority of the federal courts to order any form of appropriate equitable relief for a violation of the Federal securities laws.[22]

The Committee recognizes that corporate governance issues are generally regulated by state law, and these corporate bar provisions are not intended to establish Federal standards governing the qualifications of corporate officers or directors. Rather, they are intended to protect public investors from persons who, by engaging in fraudulent conduct, already have demonstrated that they should not be entrusted with authority over investor funds. Some commentators have suggested that a court ordered bar infringes upon the right of shareholders to determine for themselves who should serve as their elected management. However, public shareholders may lack sufficient control to remove securities law violators from office or otherwise to protect their own interests. In addition, in some cases, the shareholders may have been the direct beneficiaries of the wrongdoing and thus may have little economic incentive to vote out the violators. Moreover, broader public interests are involved when the actions of the violator undermine the integrity of the markets.

Although the express authority to grant this relief is not limited to corporate officers or directors, the Committee believes the remedy of a bar or suspension from service as a corporate officer or director is especially appropriate in cases in which a defendant has engaged in fraudulent conduct while serving in a corporate or other fiduciary capacity. For example, in *SEC* v. *Florafax International, Inc.*,[23] the SEC filed an injunctive action against the chair-

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[21] Courts have employed this remedy in a number of cases pursuant to a consent decree and in at least one litigated case. *See SEC* v. *Techni-Culture, Inc.*, [1973–74 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,501 (CCH) (D. Ariz. 1974), where the court ordered a bar against the defendant "except upon a showing to the court that measures have been taken to prevent repetition of the conduct alleged" in the SEC's complaint, or similar conduct.

[22] *See J.I. Case Company* v. *Borak*, 377 U.S. 426 (1964) (holding that under the Exchange Act, a court is entitled to provide all relief necessary for the protection of investors). *See also SEC* v. *Materia*, 745 F. 2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1984) (once equity jurisdiction is properly invoked, court has power to order all equitable relief necessary under the circumstances).

[23] Lit. Rel. No. 10617, 31 SEC Docket 1425 (N.D. Okla. 1984).

man of the board of directors and chief executive officer of Florafax. The SEC's complaint alleged that he had aided and abetted the filing with the SEC of materially false financial statements of the company. The defendant, as part of a settlement, agreed, without admitting or denying the allegations of the SEC's complaint, to an injunction against further violations of certain provisions of the Securities Act and the Exchange Act and to be barred from serving as an officer of the company for a period of three years. Prior to the *Florafax* proceedings, the chief executive officer had been enjoined in an SEC action and convicted of securities laws violations as a result of his conduct as the chief executive officer of another corporation.[24]

In *SEC* v. *American Commonwealth Financial Corp.*,[25] the SEC brought an action against several persons, including a controlling shareholder of an issuer who also served as an officer. The SEC's complaint alleged that the defendants had made fraudulent filings with the SEC, as part of a scheme in which the defendants used the assets of public companies for their personal gain. The controlling shareholder agreed, without admitting or denying the SEC's allegations, to an injunction against further violations of the antifraud provisions of the Securities Act and the Exchange Act and to resign as an officer. The Committee expects that the SEC will continue its practice of seeking this remedy in similar cases against defendants who have demonstrated a propensity to violate their fiduciary duty or have otherwise demonstrated substantial unfitness to serve as an officer or director.

D. ACCESS TO GRAND JURY INFORMATION

Section 501 of the legislation adds Section 3323 to the Federal Criminal Code to authorize a court to approve the disclosure of grand jury information to the SEC for use in enforcing the federal securities laws. This authority will significantly enhance the SEC's ability to obtain information from criminal authorities and will avoid costly and time-consuming duplication of efforts to gather information already in the hands of government officials. The provision is modeled after Section 3322, which was recently added to title 18 of the United States Code by Section 964 of FIRREA, in order to give banking and thrift regulators greater access to grand jury information.

Under current law, Rule 6(e) of the Federal Rules of Criminal Procedure permits disclosure of matters occurring before a grand jury when so directed by a court "preliminarily to or in connection with a judicial proceeding." Such an order may be granted only upon a showing of "particularized need" for the information. Section 3323, like Section 3322, is a response to two Supreme Court decisions concerning Rule 6(e). These decisions have made it more difficult for the SEC to get access to relevant information regarding violations of the securities laws obtained in criminal investigations.

In *United States* v. *Baggot*,[26] the Supreme Court narrowly defined the purpose for which disclosure may be made under Rule

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[24] *See SEC* v. *World-Wide Coin Investments, Ltd.*, 567 F. Supp. 724 (N.D. Ga. 1983); *United States* v. *Hale*, Lit. Rel. No. 10635, 32 SEC Docket 157 (N.D. Ga. 1984).

[25] Lit. Re. No. 7920, 12 SEC Docket 421 (N.D. Tex. 1977).

[26] 463 U.S. 476 (1983).

6(e). The Court held that certain agency proceedings, such as civil tax audits, are not preliminary to a judicial proceeding within the meaning of Rule 6(e) and that a court order may not be secured for disclosure of grand jury information in connection with such agency proceedings. In a companion case, *United States* v. *Sells Engineering, Inc.*,[27] the Court noted that it had consistently held that disclosure of grand jury material would only be permitted upon a showing of "particularized need." In describing this standard, the Court noted that disclosure "is appropriate only in those cases where the need for it outweighs the public interest in secrecy, and the burden of demonstrating this balance rests upon the private party seeking disclosure." [28] The Court observed that a court could take into account any alternative discovery tools available by statute or regulation to the agency seeking disclosure.

Some commentators have suggested that the particularized need standard is not satisfied by a showing that non-disclosure would cause lengthy delays in litigation or would require substantial duplication of work. If so interpreted, grand jury information could not be disclosed to the SEC under Rule 6(e), even if non-disclosure would result in substantial duplication of investigative efforts. Section 3323 is intended to avoid such undesirable results.

In the last several years, the SEC has been faced with decisions involving the institution of enforcement proceedings or the imposition of sanctions without the benefit of the substantial investigative record developed in contemporaneous grand jury proceedings. For example, the SEC recently settled its largest civil enforcement proceeding brought against an individual. In this case, the SEC was required to rely exclusively upon the information developed in its own investigation. It could not obtain access to any of the voluminous information developed during the lengthy grand jury proceedings. While the SEC has assured the Committee that it is satisfied that the settlement adequately resolved all of the issues raised by its complaint and by the SEC's underlying investigation, access to the grand jury information would have enabled the SEC to make a more complete assessment of the individual's potential culpability, as well as that of numerous other persons with whom he had business dealings. S. 647 would enable the SEC to make more informed and timely enforcement decisions and better protect the public interest, particularly in critical cases in which there are parallel civil and criminal investigations.

In recent years, the SEC has become increasingly involved in major investigations of conduct that also requires investigation and response by Federal criminal prosecutors. Because of the SEC's expertise, it often is asked to devote substantial resources to assist Federal prosecutors in investigating securities fraud and related matters. This assistance often includes detailing SEC personnel to assist grand jury investigations. The effect of Rule 6(e) has been to make it difficult for detailed personnel to assist SEC investigations or enforcement actions involving the same wrongdoing, regardless of the fact that the criminal proceeding may be complete or the grand jury did not return an indictment. As a consequence, SEC

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[27] 463 U.S. 418 (1983).

[28] *Id.* at 443, citing *Douglas Oil* v. *Petrol Stops Northwest*, 441 U.S. 211, 222–223 (1979).

assistance to Federal prosecutors not only results in the loss of trained investigative personnel, but also results in the SEC being restricted from access to the very information obtained through its assistance. Thus, the SEC is required to duplicate investigative efforts, resulting in waste of government resources. Under the legislation, SEC personnel who assist grand jury investigations will not be later foreclosed from assisting the agency in investigating or litigating violations of the securities laws arising out of the same misconduct.

Section 3323 will assist the SEC's law enforcement efforts in a number of other significant circumstances. For example, in cases in which the prosecutors conclude that a particular matter before the grand jury does not warrant a criminal indictment but may nonetheless warrant a civil or administrative enforcement action, it will allow the criminal prosecutors to share important information with the SEC when the proper showing is made to the court. Under current law, the criminal prosecutors may not bring such matters to the SEC's attention. In addition, Section 3323 will enable the SEC to respond more promptly and effectively when the SEC learns that criminal wrongdoing has occurred that may disqualify a person from engaging in certain activities under the Federal securities laws.

The Committee also notes that the SEC had dedicated substantial resources to investigating securities fraud and other wrongdoing involving banks and savings and loan institutions. The SEC should be on equal footing with the bank regulators in obtaining grand jury information to assist in investigating and prosecuting serious wrongdoing by persons associated with financial institutions.

Description of section 3323.—Section 3323 authorizes prosecutors to seek court approval to release grand jury information to the SEC for use in matters within the SEC's jurisdiction. The Committee believes it is appropriate to eliminate the requirement that court-authorized disclosure be limited to use preliminary to or in connection with a "judicial proceeding" in order to clarify that the disclosure also may be used preliminarily to, or in connection with, an SEC inquiry or investigation. The bill would do this and would also reduce the "particularized need" standard to a "substantial need in the public interest" standard.

The "substantial need in the public interest" standard that must be satisfied prior to disclosure under Section 3323 ensures effective control by the courts over the disclosure of grand jury information to the SEC. The public interest standard includes particularly the protection of investors. Other factors that the court may consider under the substantial need standard include (1) the burden or cost of duplicating the grand jury investigation; (2) the potential unavailability of witnesses; (3) the fact that the SEC already has a legitimate independent right to the materials; (4) the avoidance of inefficiency or waste of resources; (5) the need to prevent ongoing violations of law; and (6) the expiration of an applicable statute of limitations.

Section 3322 authorizes "disclosure of matters occurring before a grand jury during an investigation of a banking law violation" (defined to include mail and wire fraud) to identified personnel of a

financial institution regulatory agency. Proposed section 3323 similarly permits disclosure to SEC personnel of matters occurring before a grand jury during an investigation "of conduct that may constitute a violation of the federal securities laws." The Committee believes that Section 3323 should be slightly broader than Section 3322, in order to cover not simply grand jury investigations of securities law violations, but also investigations of other kinds of conduct (such as mail or wire fraud) that may constitute violations of the securities laws. This is important because grand juries may often investigate conduct constituting violations of more general federal criminal statutes, but, in the course of these investigations, may uncover related violations of the securities laws.

E. ACCEPTANCE BY STOCK TRANSFER AGENTS OF SIGNATURE GUARANTEES FROM ALL FINANCIAL INSTITUTIONS

Section 601 of the legislation adds a new paragraph to Section 17A(d) of the Exchange Act, to make clear the SEC's authority to ensure that all financial institutions are treated equally with respect to signature guarantee services. While state law currently governs transfer agent liability for signature endorsement, the SEC is directed by Section 17A of the Exchange Act to regulate transfer agent activities as part of a mandate to protect investors through the prompt and accurate clearance and settlement of securities transactions. In that regard, the SEC has an interest in ensuring that transfer agent standards for signature guarantees do not impose unnecessary burdens on investors and persons facilitating transactions by and on behalf of investors. Indeed, investor protection is promoted by convenience in transferring securities. However, most stock transfer agents currently accept signature guarantees from members of national stock exchanges and commercial bank and trust companies, but not from savings and loan institutions, savings banks, or credit unions, even though these institutions are authorized to guarantee signatures for securities transfer.

Transfer agents' nonacceptance of signature guarantees from some financial institutions means that those institutions' customers must use the services of a bank, with which they may have no prior relationship, in order to effect the transfer of ownership of securities. This discriminatory treatment of some financial institutions imposes unnecessary burdens on investors and persons facilitating transactions by and on behalf of investors. The SEC has encouraged a private sector resolution to this problem, but its efforts have not met with success. Thus, a legislative response is necessary. Section 601 would enhance investor protection by promoting convenience in the transfer of securities.

The new language prohibits any registered transfer agent from engaging in any activity in connection with signature guarantees, including the acceptance or rejection of a signature guarantee, in contravention of SEC rules and regulations prescribed for the protection of investors and the facilitation of equitable treatment of financial institutions which issue these guarantees. The Committee does not intend, however, that transfer agents be forced to accept signature guarantees from institutions whose financial condition is such that they cannot meet the financial obligations under the

guarantee. Thus, differentiation based upon objective measures of an individual institution's financial condition would be permissible, while discrimination based upon an institution's charter, whether the institution is a thrift, a credit union, a bank or broker-dealer, would not.

SECTION-BY-SECTION ANALYSIS OF S. 647

SECTION 1: SHORT TITLE

This section provides that the short title of the bill is the "Securities Law Enforcement Remedies Act of 1990". The Act applies to any conduct occurring after the date of enactment.

TITLE I: AMENDMENTS TO THE SECURITIES ACT OF 1933

This title of the bill amends the Securities Act of 1933 (Securities Act) to authorize a court in a civil action brought by the SEC to impose money penalties for violations of the Securities Act, to expressly affirm the authority of a court to bar persons who have violated Section 17(a)(1) of the Securities Act from serving as officers or directors of a publicly-held company, and to authorize the SEC to issue both temporary and permanent cease-and-desist orders and order an accounting and disgorgement.

Section 101

Section 101 of the Act amends Section 20 of the Securities Act by adding new subsections (d) and (e). The section references in the following analysis refer to Section 20 of the Securities Act, as amended by S. 647.

Section 20(d)(1)—Money penalties in civil actions: Authority of Commission.—Section 20(d)(1) provides that whenever it appears to the SEC that any person has violated any of the provisions of the Securities Act, or the rules or regulations promulgated thereunder, or a cease-and-desist order issued pursuant to the SEC's authority under the Securities Act (other than an insider trading violation subject to a penalty under Section 21A of the Securities Exchange Act of 1934 (Exchange Act)), the SEC may bring an action in Federal district court to seek a civil penalty to be paid by the person who committed such violation. A Federal district court may impose such penalties upon a proper showing.

Section 20(d)(2)—Money penalties in civil actions: Amount of penalty.—This section provides that the amount of the penalty shall be determined by the court in light of the facts and circumstances in the particular case. There are three tiers of maximum penalty amounts.

Section 20(d)(2)(A) provides that for each violation, the amount of the penalty may not exceed the greater of (1) $5,000 for a natural person or $50,000 for any other person or (2) the gross amount of pecuniary gain to the defendant as a result of the violation.

Section 20(d)(2)(B) provides that if the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, the penalty for each violation may not exceed the greater of (1) $50,000 for a natural person or $250,000 for any

other person or (2) the gross amount of pecuniary gain to the defendant as a result of the violation.

Section 20(d)(2)(C) provides that if the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and the violation resulted in substantial losses or created a significant risk of substantial losses to other persons, the penalty for each violation may not exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person or (2) the gross amount of pecuniary gain to such defendant as a result of the violation.

Section 20(d)(3)—Money penalties in civil actions: Procedures for collection.—Section 20(d)(3) provides that penalties are payable into the Treasury. If a person upon whom a penalty is imposed fails to pay the penalty within the time prescribed by the court, the SEC may refer the matter to the Attorney General who shall recover the penalty by action in the appropriate U.S. district court. Section 20(d)(3)(C) provides that actions brought under Section 20(d) may be brought in addition to any other action that the SEC or the Attorney General is entitled to bring. For purposes of Section 22 of the Securities Act, actions under the section shall be actions to enforce a liability or a duty created by the Securities Act.

Section 20(d)(4)—Money penalties in civil actions: Special provisions relating to a violation of a cease-and-desist order.—Section 20(d)(4) provides that in an action to enforce a cease-and-desist order entered by the SEC under the Securities Act, each separate violation of the order is a separate offense, except that in the case of a violation through a continuing failure to comply with a cease-and-desist order, each day of the failure to comply is deemed a separate offense.

Section 20(e)—Authority of a court to prohibit persons from serving as officers and directors.—Section 20(e) expressly affirms the existing authority of Federal district courts to prohibit, conditionally or unconditionally, permanently or for such period of time as it shall determine, any person who has violated Section 17(a)(1) of the Securities Act from serving as officers or directors of any issuer that has a class of securities registered under Section 12 of the Exchange Act or that is required to file periodic reports under Section 15(d) of the Exchange Act. Section 20(e) requires that the person's conduct demonstrates substantial unfitness to serve as an officer or director of such an issuer before a court enters an order pursuant to this section.

Section 102

Section 102 of the Act adds new Section 8A to the Securities Act. The section references in the following analysis refer to Section 8A of the Securities Act, as amended by S. 647.

Section 8A(a)—Cease-and-desist proceedings: Authority of commission.—Under Section 8A(a), if the SEC finds, after notice and an opportunity for a hearing, that any person is violating, has violated, or is about to violate any provision of the Securities Act or any rule or regulation promulgated thereunder, the SEC may enter an order requiring such person or any other person that is, was, or would be a cause of the violation, due to an act or omission such other person knew or should have known would contribute to such

violation, to cease-and-desist from committing or causing such violation and any future violation of the same provision, rule or regulation. The SEC's order also may require such person to comply, or to take steps to effect compliance, with such provision, rule or regulation or may require future compliance. The order may be permanent or for such period of time as the SEC may specify.

Section 8A(b)—Cease-and-desist proceedings: Hearing.—Section 8A(b) requires that a hearing must be set no earlier than thirty days and no later than sixty days after issuance of the notice, unless the SEC sets an earlier or later date with the consent of the respondent.

Section 8A(c)—Cease-and-desist proceedings: Temporary order.—Section 8A(c) authorizes the SEC to issue a temporary cease-and-desist order whenever it determines that a violation or a threatened violation is likely to result in significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest before a proceeding on a permanent cease-and-desist order could be completed. A temporary order may require the respondent to refrain from the violation or threatened violation, or may require the respondent to take action to prevent the violation or threatened violation and to prevent dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest as the SEC deems appropriate pending completion of the proceeding.

The SEC is required to give the respondent notice prior to the imposition of a temporary cease-and-desist order, unless the SEC determines that such notice is impracticable or contrary to the public interest. If the SEC determines that notice of the temporary order is impracticable or contrary to the public interest, the order will become effective upon service on the respondent. A temporary order remains in effect unless set aside, limited, or suspended by the SEC or a court, pending the completion of the permanent cease-and-desist proceedings.

Section 8A(c)(2) provides that the SEC may only impose temporary orders on a respondent that acts, or, at the time of the alleged misconduct acted, as a broker, dealer, investment adviser, investment company, municipal securities dealer, government securities broker, government securities dealer, or transfer agent or is, or was at the time of the alleged misconduct, an associated person of any of the foregoing.

Section 8A(d)—Review of temporary order.—Section 8A(d)(1) provides that within 10 days after a respondent who has been served with a temporary cease-and-desist order, the respondent may apply to an appropriate Federal district court for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order. Section 8A(d)(3) provides that commencement of such a judicial proceeding will not operate as a stay of a temporary order unless specifically ordered by the court.

Under Section 8A(d)(2), a respondent may apply to the SEC to have a temporary order set aside, limited, or suspended, and the SEC may enter such an order.

Because of the provision for review of a temporary order in Federal district court, Section 8A(d)(4) provides that Section 9(a) of the Securities Act, which provides generally for appellate review of

SEC orders in the United States courts of appeals, does not apply to review of the SEC's temporary cease-and-desist orders.

Section 8A(e)—Authority to enter an order requiring an accounting and disgorgement.—Section 8A(e) provides that the SEC may enter an order requiring accounting and disgorgement, including reasonable interest, in any permanent cease-and-desist proceeding. The SEC is given rulemaking authority to implement this subsection.

TITLE II: AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934

This title of the bill amends the Securities Exchange Act of 1934 (Exchange Act) to authorize a court, ~~in civil actions~~ brought by the SEC, and the SEC, in administrative actions, to impose civil money penalties for violations of the Exchange Act, to expressly affirm the authority of a court to bar persons who have violated Section 10(b) of the Exchange Act or the rules or regulations thereunder from serving as officers or directors of publicly-held companies, and to authorize the SEC to issue both temporary and permanent cease-and-desist orders and enter an order requiring an accounting and disgorgement. In addition, Section 205 of Title II authorizes the SEC to issue rules and regulations to prevent certain discriminatory acts by transfer agents with respect to the acceptance of signature guarantees.

Section 201

Section 201 of the Act amends Section 21 of the Exchange Act by redesignating subsection (d) as subsection (d)(1) and adding new subsection (d)(2). The section references in the following analysis refer to Section 21 of the Exchange Act, as amended by S. 647.

Section 21(d)(2)—Authority of a court to prohibit persons from serving as officers and directors.—Section 21(d)(2) expressly affirms the existing authority of Federal district courts to prohibit, conditionally or unconditionally, and permanently or for such period of time as it shall determine, any person who violated Section 10(b) of the Exchange Act, or the rules or regulations thereunder, from acting as an officer or director of any issuer that has a class of securities registered under Section 12 of the Exchange Act or that is required to file periodic reports under Section 15(d) of the Exchange Act, if the person's conduct demonstrates substantial unfitness to serve as an officer or director of any such issuer. This section parallels new Section 20(e) of the Securities Act.

Section 21(d)(3)—Money penalties in civil action.—Section 21(d)(3)(A) provides that whenever it appears to the SEC that any person has violated any of the provisions of the Exchange Act, or the rules or regulations promulgated thereunder or a cease-and-desist order issued pursuant to the SEC's authority under the Exchange Act (other than an insider trading violation subject to a penalty under Section 21A of the Exchange Act), the SEC may bring an action in Federal district court to seek a civil penalty to be paid by the person who committed such violation. A Federal district court may impose such penalties upon a proper showing. This section parallels new Section 20(d)(1) of the Securities Act.

Section 21(d)(3)(B) provides three tiers of maximum penalty amounts, similar to those provided in new Section 20(d)(2) of the Securities Act. Similarly, Sections 21(d)(3)(C) and 21(d)(3)(D), dealing with procedures for collections of such fines and the scope of each violation, parallel new Sections 20(d)(3) and 20(d)(4) of the Securities Act.

Section 202

Section 202 of the Act amends the Exchange Act by adding new Section 21B. The section references in the following analysis refer to Section 21B of the Exchange Act, as amended by S. 647.

Section 21B(a)—Civil remedies in administrative proceedings: Commission authority to assess money penalties.—Section 21B(a) authorizes the SEC or other appropriate regulatory agency to impose civil penalties in administrative proceedings instituted pursuant to Sections 15(b)(4), 15(b)(6), 15B, 15C and 17A of the Exchange Act. The SEC or other appropriate regulatory agency may assess a penalty if it finds that the penalty is in the public interest and the respondent (1) has willfully violated any provision of the Securities Act, the Exchange Act, the Investment Company Act of 1940 (Investment Company Act), the Investment Advisers Act of 1940 (Investment Advisers Act), or the rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board; (2) has willfully aided, abetted, counseled, commanded, induced or procured a violation by any other person; (3) has willfully made or caused to be made in any application for registration or report required to be filed with the SEC or with any other appropriate regulatory agency under the Exchange Act, or in any proceeding before the SEC with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or (4) has failed reasonably to supervise within the meaning of Section 15(b)(4)(E), with a view to preventing violations of the Federal securities laws, another person who committed a violation, if the other person was subject to his supervision.

Section 21B(b)—Civil remedies in administrative proceedings: Maximum amount of penalty.—Section 21B(b) provides three tiers of maximum penalty amounts in SEC administrative proceedings. Under the first tier, the maximum penalty for each act or omission described in Section 21B(a) is $5,000 for a natural person or $50,000 for any other person. If the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, the maximum penalty for each act or omission is $50,000 for a natural person or $250,000 for any other person. If the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement and the act or omission resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission, the maximum penalty for each act or omission is $100,000 for a natural person or $500,000 for any other person.

Section 21B(c)—Civil remedies in administrative proceedings: Determination of public interest.—In order to assess a penalty, the SEC or other appropriate regulatory agency must determine that a penalty is in the public interest. Section 21B(c) provides that, in making this determination, the SEC or other appropriate regulatory agency may consider the following factors:

(1) Whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

(2) The harm to other persons resulting either directly or indirectly from such act or omission;

(3) The extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

(4) Whether such person previously has been found by the SEC, other appropriate regulatory agency, or self-regulatory organization to have violated the Federal securities laws, state securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted of violations of such laws or of any felony or misdemeanor described in Section 15(b)(4)(B) of the Exchange Act;

(5) The need to deter such person and other persons from committing such acts or omissions; and

(6) Such other matters as justice may require.

Section 21B(d)—Civil remedies in administrative proceedings: Evidence concerning ability to pay.—Section 21B(d) provides that a respondent may present evidence to the SEC or other appropriate regulatory agency regarding the respondent's ability to pay a penalty imposed by the SEC or the appropriate regulatory agency under this section. The SEC or the appropriate regulatory agency may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. The respondent's evidence may relate to the extent of his ability to continue in business and the collectability of the penalty, taking into account other claims of the United States or third parties upon his assets and the amount of his assets.

Section 21B(e)—Civil remedies in administrative proceedings: Authority to enter an order requiring an accounting or disgorgement.—Section 21B(e) provides that the SEC or the appropriate regulatory agency may enter an order requiring an accounting and disgorgement, including reasonable interest, in any proceeding in which a penalty may be imposed under Section 21B. The SEC is given rulemaking authority to implement this subsection.

Section 203

Section 203 of the Act amends the Exchange Act by adding new Section 21C. The section references in the following analysis refer to Section 21C of the Exchange Act, as amended by S. 647.

Section 21C—Cease-and-desist authority.—Section 21C authorizes the SEC to issue permanent and temporary cease-and-desist orders to enforce the provisions of the Exchange Act and to enter an order requiring an accounting and disgorgement in permanent cease-and-

desist proceedings. The authority granted under this section parallels new Section 8A of the Securities Act.

Section 204

Section 204 of the Act amends Section 15B(c)(6)(A) of the Exchange Act. The section references in the following analysis refer to Section 15B(c)(6)(A) of the Exchange Act, as amended by S. 647.

Section 15B(c)(6)(A)—Conforming amendments to section 15B.—Section 15B requires the SEC to inform the appropriate regulatory agency for a municipal securities dealer when the SEC is seeking a penalty pursuant to an administrative proceeding against the dealer pursuant to Section 21B of the Exchange Act.

Section 205

Section 205 of the Act amends Section 17A(d) of the Exchange Act by adding new subsection (5). The section references in the following analysis refer to Section 17A(d) of the Exchange Act, as amended by S. 647.

Section 17A(d)(5)—Signature guarantees.—Section 17A(d)(5) provides that a registered transfer agent may not engage in any activity in connection with the guarantee of a signature of an endorser of a security, including the acceptance or rejection of such guarantee, in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest, for the protection of investors, to facilitate the equitable treatment of financial institutions which issue such guarantees.

TITLE III: AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

This title of the bill amends the Investment Company Act to authorize a court, in civil actions brought by the SEC, and the SEC, in administrative actions, to impose civil money penalties for violations of the Investment Company Act, and to authorize the SEC to issue both temporary and permanent cease-and-desist orders and enter an order requiring an accounting and disgorgement.

Section 301

Section 301 of the Act amends Section 9 of the Investment Company Act by redesignating subsection (d) as subsection (g) and adding new subsections (d), (e) and (f). The section references in the following analysis refer to Section 9 of the Investment Company Act, as amended by S. 647.

Section 9(d)—Money penalties in administrative proceedings.—Section 9(d)(1) authorizes the SEC to impose civil penalties in administrative proceedings instituted pursuant to Section 9(b) of the Investment Company Act. The SEC may assess a penalty if it finds that the penalty is in the public interest and the respondent (1) has willfully violated any provision of the Securities Act, the Exchange Act, the Investment Company Act, the Investment Advisers Act, or the rules or regulations thereunder; (2) has willfully aided, abetted, counseled, commanded, induced or procured a violation by any other person; or (3) has willfully made or caused to be made in any registration application or report required to be filed with the SEC under the Investment Company Act, any statement which was at

the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, or report any material fact which was required to be stated therein.

Section 9(d)(2) provides for maximum amounts for such penalties, Section 9(d)(3) provides factors that the SEC may consider when determining whether the penalty is in the public interest and Section 9(d)(4) allows respondents to show evidence concerning their ability to pay administratively imposed penalties. These sections are parallel to new Sections 21B(b), 21B(c), and 21B(d) of the Exchange Act, respectively.

Section 9(e) provides that the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest, in any proceeding in which a penalty may be imposed under Section 9(d). This section is parallel to new Section 21B(e) of the Exchange Act.

Section 9(f) authorizes the SEC to issue permanent and temporary cease-and-desist orders to enforce the provisions of the Investment Company Act and to enter an order requiring an accounting and disgorgement in permanent cease-and-desist proceedings. The authority granted under this section parallels new Section 8A of the Securities Act and new Section 21C of the Exchange Act.

Section 9(g) provides that the term "investment adviser" applies to all of Section 9.

Section 302

Section 302 of the Act amends Section 42 of the Investment Company Act by adding new subsection (e). The section references in the following analysis refer to Section 42 of the Investment Company Act, as amended by S. 647.

Section 42(e)—Money penalties in civil actions.—Section 42(e)(1) provides that whenever it appears to the SEC that any person has violated any of the provisions of the Investment Company Act, or the rules or regulations promulgated thereunder, or a cease-and-desist order issued pursuant to the SEC's authority under the Investment Company Act, the SEC may bring an action in Federal district court to seek a civil penalty to be paid by the person who committed such violation. Section 42(e)(1) also provides that a Federal district court may impose such penalties upon a proper showing. This section parallels new Section 20(d)(1) of the Securities Act and new Section 21(d)(3)(A) of the Exchange Act.

Section 42(e)(2) provides three tiers of maximum penalty amounts, similar to those provided in new Section 20(d)(2) of the Securities Act and new Section 21(d)(3)(B) of the Exchange Act. Similarly, Sections 42(e)(3) and 42(e)(4), dealing with procedures for collections of such fines and the scope of each violation, parallel new Sections 20(d)(3) and 20(d)(4) of the Securities Act and new Sections 21(d)(3)(C) and 21(d)(3)(D) of the Exchange Act, respectively.

TITLE IV: AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

This title of the bill amends the Investment Advisers Act to authorize a court, in civil actions brought by the SEC, and the SEC, in administrative actions, to impose civil money penalties for viola-

tions of the Investment Advisers Act, and to authorize the SEC to issue both temporary and permanent cease-and-desist orders and enter an order requiring an accounting and disgorgement.

Section 401

Section 401 of the Act amends Section 203 of the Investment Advisers Act by adding new subsections (i), (j) and (k). The section references in the following analysis refer to Section 203 of the Investment Advisers Act, as amended by S. 647.

Section 203(i)—Money penalties in administrative proceedings.—Section 203(i)(1) authorizes the SEC to impose civil penalties in administrative proceedings instituted pursuant to Section 203(e) or 203(f) of the Investment Advisers Act. The SEC may assess a penalty if it finds that the penalty is in the public interest and the respondent (1) has willfully violated any provision of the Securities Act, the Exchange Act, the Investment Company Act, the Investment Advisers Act, or the rules or regulations thereunder; (2) has willfully aided, abetted, counseled, commanded, induced or procured a violation by any other person; (3) has willfully made or caused to be made in any application for registration or report required to be filed with the SEC under the Investment Advisers Act, or in any proceeding before the SEC with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application or report any material fact which was required to be stated therein; or (4) failed reasonably to supervise, within the meaning of Section 203(e)(5) of the Investment Advisers Act, with a view to preventing violations of the Investment Advisers Act and such rules or regulations, another person who committed a violation, if the other person was subject to his supervision. This section is parallel to new Section 21B(a) of the Exchange Act.

Section 203(i)(2) provides for maximum amounts for such penalties. Section 203(i)(3) provides factors that the SEC may consider when determining whether the penalty is in the public interest and Section 203(i)(4) allows respondents to show evidence concerning their ability to pay administratively imposed penalties. These sections are parallel to new Sections 21B(b), 21B(c), and 21B(d) of the Exchange Act, and new Sections 9(d)(2), 9(d)(3), and 9(d)(4) of the Investment Company Act, respectively.

Section 203(j) provides that the SEC may enter an order requiring an accounting and disgorgement, including reasonable interest, in any proceeding in which a penalty may be imposed under Section 203. This section is parallel to new Section 21B(e) of the Exchange Act and new Section 9(e) of the Investment Company Act.

Section 203(k) authorizes the SEC to issue permanent and temporary cease-and-desist orders to enforce the provisions of the Investment Advisers Act and to enter an order requiring an accounting and disgorgement in permanent cease-and-desist proceedings. The authority granted under this section parallels new Section 8A of the Securities Act, new Section 21C of the Exchange Act and new Section 9(f) of the Investment Company Act.

Section 402

Section 402 of the Act amends Section 209 of the Investment Advisers Act by adding new subsection (e). The section references in the following analysis refer to Section 209 of the Investment Advisers Act, as amended by S. 647.

Section 209(e)—Money penalties in civil actions.—Section 209(e) provides that whenever it appears to the SEC that any person has violated any of the provisions of the Investment Advisers Act, or the rules or regulations promulgated thereunder, or a cease-and-desist order issued pursuant to the SEC's authority under the Investment Advisers Act, the SEC may bring an action in Federal district court to seek a civil penalty to be paid by the person who committed such violation. Section 209(e) also provides that a Federal district court may impose such penalties upon a proper showing. This section parallels new Section 20(d)(1) of the Securities Act, new Section 21(d)(3)(A) of the Exchange Act, and new Section 42(e)(1) of the Investment Company Act.

Section 209(e)(2) provides three tiers of maximum penalty amounts, similar to those provided in new Section 20(d)(2) of the Securities Act, new Section 21(d)(3)(B) of the Exchange Act and new Section 42(e)(2) of the Investment Company Act. Similarly, Sections 209(e)(3) and 209(e)(4), dealing with procedures for collections of such fines and scope of each violation parallel new Sections 20(d)(3) and 20(d)(4) of the Securities Act, new Sections 21(d)(3)(C) and 21(d)(3)(D) of the Exchange Act and new Sections 42(e)(3) and 42(e)(4) of the Investment Company Act, respectively.

Section 403

Section 403 of the Act amends Section 214 of the Investment Advisers Act. The section references in the following analysis refer to Section 214 of the Investment Advisers Act, as amended by S. 647.

Section 214—Conforming amendments to section 214.—Section 214 is amended to expand the jurisdiction of the Federal district courts to include actions at law, as well as equitable or injunctive actions, under the Investment Advisers Act. This amendment is necessitated by the addition of new Section 209(e), the civil penalty provision, to the Investment Advisers Act, since that section confers jurisdiction over penalty actions to the Federal district courts.

TITLE V: AMENDMENTS TO THE CRIMINAL CODE

This title of the bill amends the United States Criminal Code to authorize a court, upon motion of an attorney for the government, to disclose grand jury materials to identified personnel of the SEC.

Section 501

Section 501 of the Act amends the United States Criminal Code by adding new Section 3323. The section references in the following analysis refer to Section 3323 of the United States Criminal Code, as amended by S. 647.

Section 3323—Disclosure of certain matters occurring before grand jury for use in enforcing securities laws.—Section 3323 provides that upon motion of an attorney for the government, a court may direct disclosure of matters occurring before a grand jury

during an investigation of conduct that may constitute a violation of any provision of the Federal securities laws to identified personnel of the SEC for use in relation to any matter within the jurisdiction of the SEC. A court may direct that grand jury information be released upon a finding of a substantial need in the public interest. SEC personnel may use grand jury information only for the purpose for which such disclosure was authorized.

Regulatory Impact Statement

In compliance with paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement regarding the regulatory impact of the bill. This bill will strengthen the enforcement powers of the SEC by authorizing new civil penalties for securities law violations, providing cease-and-desist authority for the SEC, affirming the authority of Federal courts to bar persons from serving as officers and directors of publicly-held companies under certain circumstances, authorizing Federal courts to grant access to the SEC to grand jury material under certain circumstances, and providing authority to the SEC to write rules to prohibit discrimination by transfer agents with respect to signature guarantees, with minimal overall increase in regulatory burden.

Changes in Existing Law

In the opinion of the Committee, it is necessary to dispense with the requirement of subsection 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

Cost of the Legislation

The Committee has requested a cost estimate of this legislation under the provisions of Section 403 of the Congressional Budget Act of 1974. The cost estimate of the Congressional Budget Office appears below:

U.S. Congress,
Congressional Budget Office,
Washington, DC, June 14, 1990.

Hon. Donald W. Riegle, Jr.,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC.

Dear Mr. Chairman: The Congressional Budget Office has reviewed S. 647, the Securities Law Enforcement Remedies Act of 1990, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs, May 24, 1990. We estimate that implementation of this bill would result in additional costs to the federal government of about $1 million annually, assuming appropriation of the necessary funds. The new fines that are established by the bill could increase receipts to the federal government. We have no basis, however, for predicting the amount of any such receipts.

S. 647 would strengthen the Securities and Exchange Commission's (SEC) enforcement powers by authorizing the imposition of civil fines for certain securities law violations. The bill also would authorize the SEC to issue both temporary and permanent cease-and-desist orders and to order that illicit profits be given up by per-

sons convicted of securities law violations. Under the legislation, a person would be provided with notice and an opportunity for a hearing before a permanent order is issued. In addition, S. 647 would allow a court to bar a person who has been found guilty of violating certain securities laws from serving as an officer of a publicly held company. Finally, the bill would amend the Federal Criminal Code to permit a court to direct the disclosure to the SEC of grand jury material that may constitute violations of securities laws.

Based on information provided by the SEC, we expect that the additional responsibilities placed on the SEC for increased civil litigation, administrative hearings, and management of disgorgements would cost about $1 million annually.

No costs would be incurred by state or local governments as a result of enactment of this bill.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Laura Carter, who can be reached on 226-2860.

Sincerely,

ROBERT F. HALE
(For Robert D. Reischauer, Director).

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